Auditing critical essay

Finance

Solutions Manual to accompany Auditing and Assurance Services in Malaysia Third Edition Messier/Glover/Prawitt Margaret Boh Kuala Lumpur • Boston • Burr Ridge, IL • Dubuque, IA • Madison, WI • New York • San Francisco St. Louis • Bangkok • Bogota • Caracas • Singapore • Lisbon • London • Madrid Mexico City • Milan • Montreal • New Delhi • Santiago • Seoul • Sydney • Taipei • Toronto Solutions Manual to accompany Auditing and Assurance Services in Malaysia Third EditionEducation

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the Inventory Management Process 95 Auditing Financing Process: Property, Plant, and Equipment and Prepayments 103 Auditing Financing Process: Long-Term Liabilities, Equity and Income Statement Items 111 Auditing Financing Process: Cash and Investments 116 Completing the Audit 121 Auditor's Report on Financial Statements and Special Purpose Audits 128 Professional Conduct and Ethics 136 Legal Liability and Quality Control 143 Other Assurance Engagements, Related Services, and Internal Auditing 149 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E

CHAPTER 1 An Introduction to Assurance and Financial Statement Auditing Answers to Review Questions 1-1 The study of auditing is more conceptual in nature compared to other accounting courses. Rather than focusing on learning the rules, techniques, and computations required to prepare financial statements, auditing emphasises learning a framework of analytical and logical skills to evaluate the relevance and reliability of the systems and processes responsible for financial information, as well as the information itself. To be successful, students must learn the framework and then learn to use logic and common sense in applying auditing concepts to various circumstances and situations.

Understanding auditing can improve the decision making ability of consultants, business managers, and accountants by providing a framework for evaluating the usefulness and reliability of information. 1-2 There is a need for auditing in a free-market economy because the agency relationship between an absentee owners/shareholders and the manager produces a natural conflict of interest due to the information asymmetry that exists between the owners and manager. As a result, the agent agrees to be monitored as part of his/her employment contract. Auditing appears to be a cost-effective form of monitoring. The empirical evidence suggests auditing was demanded prior to government regulation. In 1926, before it was required by law in the U. S. , independent auditors audited 82 percent of the companies on the New York Stock Exchange.

Additionally, many private companies and municipalities not subject to government regulations such as the Securities Act of 1933 and Securities Exchange Act of 1934 also demand auditing. 1-3 The agency relationship between an owner and manager produces a natural conflict of interest because of differences in the two parties'goalsand because of information asymmetry that exists between them. That is, the manager generally has more information about the " true" financial position and results of operations of the entity than the absentee owner does. If both parties seek to maximise their own self-interest, it is likely that the manager will not act in the best interest of the owner and may manipulate the information provided to the owner accordingly. 1-4 Independence is an important standard for auditors.

If an auditor is not independent of the client, users may lose confidence in the auditor's ability to report truthfully on the financial statements, and the auditor's work loses its value. From an agency perspective, if the principal (owner) knows that the auditor is not independent, the owner will not trust the auditor's work. Thus, the agent will not hire the auditor because the auditor's report will not be effective in reducing information risk from the perspective of the owner. 1-5 Management makes assertions about components of the financial statements. The independent auditor's work consists of searching for and evaluating evidence concerning assertions. The auditor develops audit objectives that relate to management's assertions. By segregating the 1

Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E assertions into more specific audit objectives, the auditor is better able to design audit procedures for obtaining sufficient appropriate evidence to test management assertions. 1-6 Assurance engagement is an independent professional service in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The conclusion is intended to enhance the degree of confidence that intended users can have about the subject matter information.

Assurance engagements thus improve the quality of information, or its context, for decision makers. Auditing (broadly defined) is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users. Auditing is a form of assurance engagements. In an audit engagement, the subject matter is the financial statements of the entity and the auditor’s conclusion in the form of an opinion enhances the credibility of the financial statements which are theresponsibilityof the management or directors of the company. -7 Materiality can be defined as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. Audit risk is defined as the risk that the auditor may unknowingly issue an inappropriate opinion on financial statements that are materially misstated. The concept of materiality is reflected in the wording of the auditor's standard audit report through the phrase " the financial statements present give a true and fair view. " This is the manner in which the auditor communicates the notion of materiality to the users of the auditor's report.

The auditor's standard report states that the audit provides only reasonable assurance that the financial statements do not contain material misstatement. The term " reasonable assurance" implies that there is some risk that a material misstatement could be present in the financial statements and the auditor will fail to detect it. 1-8 Relevance refers to whether the evidence relates to the specific audit objective being tested. If the auditor relies on evidence that relates to a different audit objective from the one being tested, an incorrect conclusion may be reached about a management assertion. Reliability refers to the truthfulness of the evidence; that is, the type of evidence usually signals the true state of the assertion or audit objective tested. -9 On most audits, it is not feasible or cost-effective to audit all transactions. For example, in a small business, the auditor might be able to examine all transactions that occurred during the period. However, it is unlikely that the owner of the business could afford to pay for such an extensive audit. For a large organisation, the sheer volume of transactions prevents the auditor from examining every transaction. Thus, there is a trade-off between the exactness or precision of the audit and its cost. Based on the principles of probability and statistics, it is not necessary to examines every item in a population to draw conclusion about the true characteristics of the population 2

Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E 1-10 The major phases of the audit are: • Preliminary engagement activities including client acceptance/continuance establishing engagement terms • Obtaining an understanding of the entity • Establish materiality and assess risks • Set overall audit strategy and develop audit plan • Perform tests of control and audit business processes and related accounts • Complete the audit • Evaluate results and issue audit report and 1-11 Under section 9(1) of the Act, a person is prohibited from acting or accepting an appointment as the auditor of a company if he is: 1) Indebted to the company or its related company in an amount exceeding RM 2, 500.) An officer of the company. 3) A partner, employer or employee of an officer of the company. 4) A partner, employee of an employee of an officer of the company. 5) A shareholder of a corporation whose employee is an officer of the company, or 6) Responsible for or if he is the partner, employer or employee of a person responsible for keeping the members' register or the register of debenture-holders of the company. 1-12 Under Section 174 of the Companies Act, 1965, there are two main requirements relating to the auditor's reporting duties: 1. The auditor must state, whether in his opinion, the financial statements have been properly drawn up in accordance ith the provisions of the Act and applicable approved accounting standards, so as to give a true and fair view of the company's state of affairs and result of operations; and matters required by section 169 to be dealt with in the financial statements; and 2. The auditor must state, whether in his opinion, the accounting and other records and the registers required by the Act to be kept by the company, have been properly kept in accordance with the Act. 1-13 An auditor appointed under the Act may resign from office at a general meeting of company or if he is not the sole auditor of the company. Otherwise, he has to hold office until the next AGM of the company. 1-14 There are two basic conditions that may result in a departure from a standard unqualified auditor's report: 1. Limitation of Audit Scope.

A scope limitation occurs when the auditor is unable to obtain the information or explanations he considers necessary for purpose of his audit. This will be the result of a lack of evidence such as an inability to conduct an audit procedure considered necessary. For example, if the auditor is unable to attend and observe the client's physical stock-take, and he is also unable to perform alternative audit procedures to verify the quantities of the inventories, this will constitute a scope limitation since the auditor would not have sufficient appropriate evidence to determine the existence and condition of the inventories as at year end date. 2. Disagreement. Disagreement arises in circumstances when the views of the auditor differ 3

Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E from the views expressed by management in the financial statements. The auditor may disagree withrespectto the accounting standard or accounting policies selected; the method of their application or the adequacy of the financial statement disclosure. 1-15 A scope limitation may lead to a qualified “ except for” or disclaimer of opinion depending on the materiality of its effect on the financial statements. A disagreement may lead to a qualified “ except for” or an adverse opinion. Answers to Multiple Choice Questions 1-16 1-17 1-18 1-19 1-20 1-21 C B B C A B 1-22 1-23 1-24 1-25 1-26 C D A C C

Solutions to Problems 1-27 A company implements internal controls as a safeguard to ensure appropriate capturing and recording of individual transactions, which are then collected into ending account balances. Ending account balances are then used to prepare the financial statements. The auditor can obtain evidence from all three steps of the accounting process. For instance, an auditor can directly test the account balance (ex. by bank statement reconciliation). This evidence is usually the highest-quality but costliest evidence. Or, the auditor can obtain indirect information by testing the individual transactions that make up an account balance. While an auditor will not have resources available to test each individual transaction, she or he can use sampling and project her or his findings onto the entire population of transactions.

The least direct method of obtaining evidence is to evaluate and test the company’s internal control to ensure that transactions are being properly handled. Auditors usually rely on a combination of evidence from all three areas. 1-28 a. Audit evidence supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor. b. Management makes assertions about components of the financial statements. For example, an entity's financial statements may contain a line item that accounts receivable are RM1, 750, 000. In this instance, management is asserting, among other things, that the entity owns the receivable and that the receivables are properly valued (i. e. , net realisable value).

Audit evidence helps the auditor determine whether management's assertions are being met. If the auditor is comfortable that he or she can provide reasonable assurance that all assertions are met for all accounts, he or she can issue a clean audit report. c. In searching for and evaluating evidence, the auditor should be concerned with the relevance and reliability of evidence. If the auditor relies on evidence that relates to a different assertion from the one being tested, an incorrect conclusion may be reached about the management assertion. Reliability refers to the ability of evidence to signal the true state of the assertion. 4 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E 1-29 a.

The auditor should perform the following preliminary engagement activities at the beginning of the current audit engagement: • Perform procedures regarding the continuance of the client relationship and the specific audit engagement. • Evaluate compliance with ethical requirements, including independence • Establish an understanding of the terms of the engagement. Performing these preliminary engagement activities helps the auditor to consider events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level. These considerations are important to ensure that the auditor maintains the necessary independence and competence to perform the engagement and there is no misunderstanding with the client as to the terms of the engagement. b.

Auditors develop an understanding of an entity's internal control in order to establish the scope of the audit. However, during the course of this work, the auditor may become aware of material weaknesses in the entity's internal control. The auditor is required to communicate this information to management and those charged with governance. The auditor may also make suggestions on how to rectify the weaknesses. The auditor's work on internal control may also have a preventive effect on the entity's employees. If the employees know that their work will be audited, they are less likely to commit errors or fraud. 1-30 a. An audit is an examination of the financial statements in accordance with approved auditing standards.

The objective of such an examination is to enable the auditor to express an opinion on whether the financial statements present a true and fair view of the financial position, results of operations, and cash flows in conformity with approved accounting standards. The auditor, after an objective evidence-gathering examination, expresses a professional opinion as to the fair presentation of financial statements. An independent expert is needed to lend credibility to the financial statements. It would not be meaningful for a company to report on itself without the assurance of an independent party because the company itself might not be objective. b. The following are the many ways in which an independent audit can be beneficial to an entity: • By serving as a basis for the extension of credit. By supplying credit rating agencies with required information. • By serving as a basis for preparation of tax returns. • By establishing amounts of losses from fire, theft, burglary, and so forth. • By determining amounts receivable or payable under (a) agreements for bonuses based on profits, (b) contracts for sharing expenses, and (c) cost-plus contracts. • By providing data for proposed changes in financial structure or supplying proper financial data in the event of a proposed sale or merger. • By serving as a basis for changes in accounting or recording. • By serving as a basis for action in bankruptcy and insolvency cases. • By determining proper execution of trust agreements. By furnishing estates with information in order to obtain proper settlements and avoid costly litigation. 5 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E • • • • • • • • By providing a review of many aspects of the organisation's activities and procedures. By establishing and/or improving internal control systems or control procedures. By providing important aid in case of tax audits, court actions, and so forth. By discouraging employees from planning errors, fraud, and so forth, by making them aware of an auditor's presence. By providing industry wide comparisons. By providing a realistic look at inventories. By reviewing adequacy of insurance coverage.

By providing the professional knowledge of an external auditor, which is generally superior to the client's bookkeeping experience. 1-31 The scope of an audit is the type and amount of audit work to be performed. The auditor’s assessments of audit risk and materiality influence the audit’s scope. For instance, if an auditor sets a lower materiality amount or would like to substantially reduce audit risk, the scope of the audit would be increased. In establishing the scope of an audit, the auditor must make decisions about the nature, extent, and timing of evidence to be gathered in order to evaluate management’s assertions. 1-32 The memo should cite the following facts: • There is a historical relationship between accounting and auditing.

When parties to the agency relationship (contract) do not possess the same amount of information (information asymmetry) there is a natural conflict of interest between the parties. For example, when an owner and manager are negotiating an employment contract, the owner may assume that the manager likely will use organisational funds for personal uses. Auditing plays an important role in such relationships. The owner and manager will consummate an employment contract only if the manager agrees to be monitored. Auditing can be used to monitor the contract agreed to by the two parties. (P. S. As an attorney, Lee should be well versed on contract law. • Auditing is also used to monitor other types of contracts for which no laws or regulations require an audit, for example, contracts between management and debt holders. • There is historical evidence of forms of auditing in the early Greek states and in U. K. during the industrial revolution. More relevant evidence is the fact that 82 percent of the NYSE companies were audited prior to the enactment of the U. S. securities laws. Additional evidence for the demand for auditing is also provided by the fact that in the U. S. many entities and municipalities not subject to the mandatory statutory audit under the law nevertheless contract for audits. -33 Students should focus on Wan’s ability to perform the audit. Because Wan is Boon’s brother-inlaw, he is not considered independent. This presents a problem, both in the perceived value of the audit and in the actual objectivity of the audit. That is, Wan may be intentionally or unintentionally biased towards May Gems rather than its creditors. Wan’s competence in this audit is also questionable. While Wan has experience in auditing, he has no experience or knowledge of jewellery business. To successfully perform an audit, Wan would need to obtain an understanding of the industry. This information will be invaluable to Wan in planning and performing the audit. Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E Solution to Discussion Case 1-34 a. It is unreasonable for investors to expect absolute assurance from an audit. This is due to the inherent limitations of the audit process, such as the need to apply judgment in determining the nature, timing and scope of tests, the use of sampling procedures to collect audit evidence, the persuasive rather than conclusive nature of much of the available evidence and the inherent limitations of internal control. Rather, an audit provides a high level of assurance that there are no material misstatements in the financial report. b.

Research studies have indicated that users of financial statements also expect auditors to report on the viability of an entity, detect all frauds that have occurred, as well as internal control effectiveness and management performance and efficiency. c. The profession has undertaken a number of inquiries in different countries aimed at reducing the expectation gap. Some examples of these, which are included in the references to the chapter, are: Australia ‘ A Research Study on Financial Reporting and Auditing—Bridging the Expectation Gap’, produced by a joint working party of both the ICAA and the ASCPA and published in 1993, contained 100 recommendations to reduce the expectation gap. A task force was set up to report on the working party’s recommendations.

The task force’s report ‘ Beyond the Gap’ was issued in 1996 and contained 26 recommendations. USA National Commission on Fraudulent Financial Reporting produced the ‘ Treadway Report’ in 1987, resulting in several new auditing standards being issued and the follow-up study by the Committee of

Sponsoring Organisations (COSO) on ' Internal Control— Integrated Framework'. Canada The MacDonald Commission, which reported in 1988 and endorsed the Treadway Commission recommendations. Something else that the profession has done is to carefully consider the auditor's duties as outlined in the auditing standards in the areas in which the expectation gaps raised above occur.

We have recently seen amendments to the going concern standard (AUS 708/ISA 570) that have clarified the auditor's responsibilities in this area, and AUS 210/ISA 240 have been revised to extend auditors' responsibilities for fraud. A recent initiative of the individual firms, which will be discussed in Chapter 13, has been changes to or the consideration of changes to the form of the audit report to better communicate auditors' responsibilities. Thus attempts are being made—ranging from improving the standards of what the auditor is doing to better communicating what the auditor has done—aimed at reducing the expectations gap in the areas where it occurs. 7

Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E CHAPTER 2 The Financial Statement Auditing Environment Answers to Review Questions 2-1 The essential components of the high-level model of business offered in the chapter are: corporate governance, objectives, strategies, processes, controls, transactions, and financial statements. Corporate governance is carried out by management and the board of directors in order to ensure that business objectives are carried out and that company assets are safeguarded. To achieve its objectives, management must formulate strategies and implement various processes which are in turn carried out through business transactions.

The entity’s internal control structure must be designed to ensure that these transactions are properly executed, captured, and processed in order to produce accurate financial statements. It is important that the auditor obtain a firm understanding of these components in order to plan the nature, timing, and extent of the audit procedures so that it is efficient and effective. 2-2 The information system must maintain a record of all businesses transactions. It should be capable of producing accurate financial reports to summarise the effects of the entity’s transactions. Internal control is required to ensure that transactions are appropriately conducted and recorded by the information system and company employees.

They provide safeguards to ensure the 1) reliability of financial reporting, 2) compliance with laws and regulations, 3) safeguarding of assets and 4) the effectiveness and efficiency of operations. Auditing standards require that the auditor obtain an understanding of internal control in planning the nature, timing, and extent of testing. 2-3 The three categories of management assertions cover every aspect of what is needed for a transaction to be handled properly, for a financial statement account to be fairly stated, and for the financial statements to be presented appropriately and to contain adequate disclosures. The management assertions form the basis for planning and evaluating the evidence that the auditor must obtain about the true and fair view of the client’s financial statements. -4 The function of IAASB is to develop and issue standards and statements on auditing, assurance and related services, and quality control standards for use around the world. The objective is to improve the quality and uniformity of auditing and assurance practices throughout the world and strengthen the public confidence in the global auditing profession. Currently, the IAASB is responsible for developing and issuing the International Standards on Auditing (ISA); the International Standards on Assurance Engagements (ISAE); the International Standards on Quality Control (ISQC); the International Standards on Review Engagements (ISRE); the International Standards on Related Services (ISRS) and the International Auditing Practice Statements (IAPS). -5 The approved standards on auditing are considered minimum standards of performance because circumstances of individual audit engagements may require the auditor to perform audit work beyond that specified in the auditing standards in order to appropriately issue an opinion that a set of financial statements present a true and fair view of the entity's financial 8 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E position and results. As a result, the auditor needs to use professional judgement in following all standards. 2-6 Management or the directors of the company are responsible for the preparation of the financial statements, in accordance with approved accounting standards, that present a true and fair view of the company's financial condition and operations. The auditor is responsible to issue an opinion in regards to the financial statements prepared by the directors.

In order to issue this opinion, the auditor must plan and perform the audit in accordance with established auditing standards to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. However, it is important to note that an auditor's unqualified opinion does not mean that errors or fraud do not exist but rather that there is reasonable assurance that they do not exist in material amounts. 2-7 An attitude of professional scepticism requires that the auditor objectively evaluate audit evidence. This means the auditor should constantly maintain a critical and questioning mind in assessing the validity of audit evidence he accumulates during the audit process. In the course of the audit, the auditor does not assume unquestioned honesty on the part of the management but neither should he assume that management is dishonest.

An attitude of professional scepticism is necessary for the auditor to identify circumstances that increase the risk of a material misstatement resulting from fraud or error, and suspicious circumstances that indicate that the financial statements are materially misstated. If the auditor suspected that there might be a material misstatement due to fraud or error, the auditor would be more sensitive to the selection and type of evidence examined. 2-8 Examples of compliance audits include (1) internal auditors determining whether corporate rules and policies are being followed by departments within the organisation, (2) an examination of tax returns of individuals and companies by the IRB for compliance with the tax laws.

Examples of operational audits include (1) an audit by the Auditor General to determine the efficiency and effectiveness of policies and programme, (2) internal auditors examining the effectiveness and efficiency of funds being spent on the entity’s computer resources, and (3) a university hiring an external auditor to examine the effectiveness and efficiency of student advisory services. Examples of forensic audits include (1) an examination by an external auditor of cash disbursements for payments to unauthorised suppliers, (2) assistance by an auditor to a Bank Negara in tracing laundered monies by organised criminals, and (3) an independent auditor helping identify hidden assets as part of adivorcesettlement. 2-9 In an audit of financial statements, the auditor expresses an opinion on whether the financial statements present a true and fair view.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. In meeting this objective, internal auditing provides analyses, appraisals, recommendations, counsel and information concerning the activities that have been audited. The objective of internal auditing includes promoting effective control throughout the organisation. Instead of looking at the financial accuracy of accounting records, the scope of internal auditing normally covers the compliance and operational aspects of an organisation's activities. 9 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E -10 The Auditor General is empowered under the Audit Act 1957 to examine and audit the accounts of the Federation , all the States and Federal Territories; public authorities and government companies. The Auditor General in his audit is to ascertain whether • All collection and custody of public moneys are safeguarded • All payments are authorised and supported by proof • All public stores are properly used, controlled and maintained. • All accounts and records are properly maintained • The provisions of Federal Constitution and the Financial Procedures Act, 1957 and other laws have been complied with. The Auditor General is empowered under section 7 of the Audit Act to call upon any person for any explanations and information he requires for the audit and he shall have access to any records, books and documents subject to his audit. -11 Economy refers to acquiring the appropriate quality and quantity of financial human and physical resources at the appropriate times and at the lowest cost. Efficiency refers to the use of financial, human and physical resources to maximise output for a given input, or minimise input for any given quantity and quality of output. Effectiveness refers to the extent to which the objective or goals are being achieved. 2-12 The advantages of forming partnership for firms offering public accounting services include availability of different expertise thus enabling the firm to provide greater variety of services, allowing individual partners to specialise, and can also share support staff and reduce office overhead and costs. -13 Public accounting firms offer financial statement audit, and other assurance services, tax services, management advisory or consulting services, secretarial and accounting and review services. 2-14 The main function of the Foundation is to act as a reviewing body of MASB and to provides its views to MASB on any projects that MASB undertakes and be responsible for all financing arrangements for the operations of MASB, including approving its budget. The functions of MASB include: • Issuing and development of new accounting standards as approved accounting standards. • Reviewing and adoption of existing accounting standards. • Issuing of statements of principles (SOPs) for financial reporting. • Development of a conceptual framework for evaluating proposed accounting standards. -15 Under the provisions of the Accountants Act, 1967, the main functions of MIA include the following: • To determine the qualifications of persons for admission as members of MIA. • To provide for the training and education of persons practising or intending to practise the profession of accountancy. • To approve, regulate and supervise the MIA Qualifying Examination. • To regulate the practice of the accountancy profession in Malaysia. 10 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E • To promote the interests of the accountancy profession in Malaysia; • To provide financial or other assistance to members or their dependants so as to protect the welfare of members.

Answers to Multiple-Choice Questions 2-16 2-17 2-18 2-19 2-20 2-21 2-22 2-23 2-24 A C C C B B D C C 2-25 2-26 2-27 2-28 2-29 2-30 2-31 2-32 B A B C A B D A Solutions to Problems 2-33 a. There are currently two sets of approved accounting standards in Malaysia: 1. The Financial Reporting Standards, or the FRS. 2. The Private Entity Reporting Standards, or the PERS. The FRS, which are based on the International Financial Reporting Standards (IFRS) are mandatory for public listed entities, their subsidiaries, associates, and companies jointly controlled by them. The PERS are for private companies, particularly those small and medium-sized companies which are owner-managed with no public interest. b.

The use of two different sets of financial reporting standards recognises the fact that smaller and privately run companies have different information needs; for example, they need not file financial statements with the securities commission or regulatory organisation for the purpose of issuing instruments in a public market; and these entities normally do not hold assets in a fiduciary capacity for a broad group of outsiders unlike companies such as insurance, securities brokers, pension funds, banks and financial institutions. The allowance for a simpler set of financial reporting standards also recognises the burden and costs on the smaller entities for having to comply with a complex set of accounting standards. 2-34 a.

The principles of corporate governance set out in the Code are: I Directors 1. Every listed company should be headed by an effective board which should lead and control the company. 2. The board should include a balance of executive directors and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision making. 3. The board should be supplied in a timely fashion with information in a form and of a quality appropriate to enable it to discharge its duties. 4. There should be a formal and transparent procedure for the appointment of new directors to the board. 11

Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E 5. II 1. 2. 3. III 1. 2. IV 1. 2. 3. All directors should be required to submit themselves for re-election at regular intervals and at least every three years. Directors' Remuneration Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully. In the case of executive directors, the component parts of remuneration should be structured so as to link rewards to corporate and individual performance. In the case of non-executive directors, the level of remuneration should reflect the experience and level of responsibilities undertaken by the particular nonexecutive concerned.

Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. The company's annual report should contain details of the remuneration of each director. Shareholders Companies and institutional shareholders should each be ready, where practicable, to enter into a dialogue based on the mutual understanding of objectives. Companies should use the AGM to communicate with private investors and encourage their participation. Accountabilityand Audit The board should present a balanced and understandable assessment of the company's position and prospects. The board should maintain a sound system of internal control to safeguard shareholder's investment and the company's assets.

The board should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors. b. To maintain good relationship between the board and shareholders, the board of directors must establish an effectivecommunicationpolicy which would enable both the board and management to communicate effectively with their shareholders, stakeholders and the public generally. The communication policy must effectively interpret the operations of the company to the shareholders and must accommodate feedback from shareholders, which should be factored into the company's business decisions. 2-35 a. b. c. d. e. f. g. h.

Type of Audit Operational Financial statement Compliance or operational Forensic Operational Operational Financial and compliance Compliance or forensic Type of Auditor Government External Internal or external Internal, external, or forensic Government or external Internal or external External External, or forensic 2-36 (i) Under Section 166A(3} of the Companies Act, the directors of a company must ensure that the accounts presented at its AGM are prepared in accordance with applicable approved accounting standards. If any director of a company fails to comply or to take all reasonable steps to secure compliance by the company with this requirement or has by his own wilful 12 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E ct been the cause of any default by the company, the director shall be guilty of an offence against the Companies Act. The penalty is imprisonment of five years or thirty thousand ringgit. However, a person shall not be sentenced to imprisonment for any offence under this provision of the Act unless in the opinion of the Court dealing with the case, the offence was committed wilfully. (ii) Under Securities Industry Regulations 1999, every listed corporation, its directors and chief executive are required to ensure that the financial statements or accounts of the corporation presented at the AGM are made out in accordance with approved accounting standards. It is an offence to contravene these requirements.

Where the Securities Commission (SC) is of the opinion that the financial statements are not in accordance with approved accounting standards, the SC may direct the listed corporation, its directors or chief executive, as the case may be, whether or not any of them have been charged with an offence in respect of the contravention: (i) to rectify the relevant financial statements or accounts, in order to ensure compliance with the approved accounting standards; (ii) to provide relevant undertakings to the SC with regard to compliance with the approved accountings; and (iii) to make such announcement as the SC deems fit in relation to any non-compliance or any rectification required; and The SC may, with the consent of any relevant regulatory authority, take such administrative action as the SC deems fits against the listed corporation, its directors or chief executive.

Upon rectification of the financial statements or accounts under the above provisions, the listed corporation, its directors or chief executive, (i) must submit the rectified financial statements or accounts to the SC within the period stipulated by the SC, and (ii) may provide the rectified financial statements or accounts to any person the listed corporation, directors or chief executive deems fit. Any person who refuses or fails to comply with a direction of the SC or breaches an undertaking under the above provisions commits an offence under the Securities Industry (Compliance with Approved Accounting Standards) Regulations 1999. 2-37 The audit failed to comply with approved standards on auditing in the following aspects: • Quality control policies and procedures ere not implemented for the audit (ISA 220) – the audit was not performed by personnel with sufficient skills and competence, and the job was carried out without proper direction, supervision and due care. The audit is to be performed by persons having adequate technical training and proficiency as an auditor. It was inappropriate for Dan Young to hire the two students to conduct the audit. The audit must be conducted by persons with proper education and experience in the field of auditing. Although a junior assistant has not completed his formal education, he may help in the conduct of the audit as long as there is proper supervision and review.

Dan Young did not review the work or the judgements of the assistants and clearly failed to quality control procedures. • The auditor should obtain an understanding of the entity environment including the internal control in order to assess the risk of material misstatement and to plan the overall audit strategy. Young did not obtain an understanding of the internal control, nor did the assistants. There appears to have been no audit examination at all. The work performed was more an accounting service than an auditing engagement. • The work is to be properly adequately planned (ISA 300). The standard requires Young to plan the audit with due care. Exercise of due care requires critical review at every level of 13

Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E • • supervision of the work done and the judgements exercised by those assisting in the examination. In this engagement, there was clearly a lack of proper and effective audit planning prior to the field work. The auditor should obtain sufficient appropriate audit evidence to draw reasonable audit conclusions. Young acquired no evidence that would support the financial statements. Young merely checked the mathematical accuracy of the records and summarised the accounts. Standard audit procedures and techniques such as inspection, observation, and inquiries were not performed.

The report should comply with professional and legal requirements under the Companies Act, 1965 and the auditor should state whether the financial statements give a true and fair view and comply with the Act and are prepared in accordance with approved accounting standards in Malaysia. 2-38 Periodic financial reporting relates to disclosure in respect of the accounts: 1) Quarterly report A listed issuer must give the Exchange for public release, an interim financial report that is prepared on a quarterly basis (“ quarterly report”), as soon as the figures have been approved by the board of directors of the listed issuer, and in any event not later than 2 months after the end of each quarter of a financial year.) Submission of annual audited accounts and annual report A listed entity must issue its annual audited accounts and annual report as follows: • The annual report must be issued to the shareholders and given to the Exchange within a period not exceeding 6 months from the close of the financial year of the listed issuer; and • The annual audited accounts together with the auditors' and directors' reports shall be given to the Exchange for public release, within a period not exceeding 4 months from the close of the financial year of the listed issuer unless the annual report is issued within a period of 4 months from the close of the financial year of the listed issuer. 2-39 a. Poor productivity can be caused by high wastage, poor co-ordination and production process or unskilled labour. Auditor should review the following areas: examples: 1. Labour – skill, training 2. Materials – quality, sufficiency, availability on timely basis 3. Plant and equipment –condition of facilities for production. Inadequate capacity? 4. Plant layout – facilitate material and workers' movement? 5. Technology – obsolete production technology 6. Co-ordination and supervision. 7.

Communication - Breakdown or lack of proper instruction 8. Idle time, wastage, spoilage. b. Sources of criteria • Historical performance – Based on actual results in prior periods. Efficiency will be evaluated by comparing performance of current period to previous period to determine whether operations have become better or worse. • Engineering standards – Criteria based on engineered standards are objective and scientific but may be time consuming an costly to develop. For example, time and motion studies can be used to determine the rates of production output. 14 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E • •

Benchmarking – An organisation may use the performance data of comparable or similar entities as benchmarks for evaluating efficiency. For certain industry, there may be generally accepted criteria which may be used. Mutual agreement – Sometimes criteria may be developed through discussion and agreement between auditor and auditee. Solution to Discussion Case 2-40 a. E is alleged to have violated the approved auditing standards as well as ethical requirements in the following ways: • They violated the quality control standard in the sense that it appeared that the staff assigned to the engagement did not have sufficient training or experience for the engagement.

Poor staff assignments, the leader's vacation, and the use of inexperienced personnel all suggest that the engagement was not adequately planned and that assistants were not properly supervised, a violation of the quality control standard for audit engagement. • E relationship with MGR's landlords and attorneys likely caused them to violate the ethical standard which requires independence in mental attitude. • The turnaround team's slow performance, the fact that the leader of the team took a vacation at a critical time, and the insufficient cost-cutting recommendations suggest that E did not exercise due professional care, which would be in violation of the fundamental ethical principle of due care. Finally, E inadequate recommendations suggests that they likely did not gather enough information about MGR's operations to allow them to implement an effective implementation strategy, which would be in violation of the audit standard on audit evidence. b. There are arguments both for and against having formal standards for accountants who consult. Advantages include potential increase in public trust, some assurance that a minimal level of service quality would be attained, and perhaps more guidance for consultants (to allow them to perform more effective consulting engagements). The primary disadvantage would result from the fact that accountants in public practice who consult compete with consulting firms comprised of non-accountants.

If standards were not thought out carefully, perhaps the standards would put accountants in public practice at a disadvantage relative to non-accountants in the sense that accountants would be subject to standards that constrain their activities or perhaps result in their not being able to compete with non-accountants in the area of fees. Note that public accountants face certain restrictions in providing consulting services to audit clients. 15 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E CHAPTER 3 Risk Assessment and Materiality Answers to Review Questions 3-1 There are certain inherent limitations in an audit that affect the detection of material misstatements. The following are the main factors that give rise to these limitations: • In the course of the audit, the auditor does not examine a 100 percent of the accounting population.

The use of testing or sampling means that there is a risk that the auditor may draw a wrong conclusion about the fairness of the account balance. • The auditor often relies on internal control in modifying the nature and extent of audit procedures. The inherent limitations of internal control, for example, the possibility of management override or collusion may affect the auditor’s ability to detect material misstatements. • The drawing of audit conclusions is based on audit evidence that is mostly persuasive rather than conclusive. 3-2 Inherent risk and control risk differ from detection risk in that inherent risk and control risk exist independently of the audit.

The levels of inherent risk and control risk are functions of the entity and its environment, and the auditor has little control over these risks. The auditor can control detection risk through the scope (nature, timing, and extent) of the audit procedures performed. Thus, detection risk has an inverse relationship with inherent risk and control risk. 3-3 Sampling risk refers to the fact that, in many instances, the auditor does not examine 100 percent of the account balance or class of transactions. Since only a subset of the population is examined, it is possible that the sample drawn is not representative of the population and a wrong conclusion may be made on the fairness of the account balance.

Non-sampling risk occurs because an auditor may use an inappropriate audit procedure, fail to detect a misstatement when applying an appropriate audit procedure, or misinterpret an audit result. 3-4 In understanding of the entity and its environment, the auditor gathers knowledge about: (1) industry, regulatory, and other external factors; (2) the nature of the entity; (3) its objectives and strategies, and related business risks; (4) measurement and, review of the entity’s financial performance; (5) internal control. 3-5 Some examples of conditions and events that may indicate the existence of business risks are: • Significant changes in the entity such as large acquisitions, reorganisations or other unusual events. Significant changes in the industry in which the entity operates. • Significant new products or services or significant new lines of business. • New locations. • Significant changes in the IT environment. • Operations in areas with unstable economies. 16 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E 3-6 Auditing standards define errors as unintentional misstatements or omissions of amounts or disclosures in financial statements. Fraud is defined as intentional misstatements that can be classified into two types: (1) misstatements arising from fraudulent financial reporting and (2) misstatements arising from misappropriation of assets.

Examples of errors include mistakes in gathering or processing from which financial statements are prepared, unreasonable accounting estimates arising from oversight or misinterpretation of facts, and mistakes in the application of accounting principles. Fraud includes intentional manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared; misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information; intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure; and theft of assets such as cash or inventory. -7 ISA 240 suggests that the auditor performs the following procedures that are designed to address the risks of fraud in revenue recognition: • Conduct substantive analytical procedures relating to revenue using disaggregated data, for example, the auditor can compare reported revenue by month and by product with comparable prior periods. • Confirm with customers certain contract terms and the absence of side agreements. For example, the terms of acceptance, delivery and payment, the right to return, cancellation and refunds. In particular, the absence of future continuing supplier's obligation. • Inquire of the entity's sales and marketing personnel regarding sales or delivery near the year end and any unusual terms or conditions associated with these transactions. Observe goods being delivered at year end and perform other appropriate sales and inventory cutoff procedures. 3-8 The audit risk model has a number of limitations. First, the model assumes that its components are independent of one another while they are likely to be dependent in the real world. Second, since the auditor assesses inherent risk and control risk, such assessments may be higher or lower than the actual inherent risk and control risk that exist for the entity. Third, the model does not separately take into account fraud risk. Last, the audit risk model does not consider the possibility of non-sampling risk 3-9 Professional standards provide very little specific guidance on how to assess what is material to a reasonable user.

As a result, auditing firms should develop policies and procedures to assist their auditors in establishing materiality judgments for the financial statements in order to minimise the variability of such judgments by firm personnel. In other words, firms would prefer to have their auditors establish similar materiality judgments for entities with similar circumstances. 3-10 The three major steps in applying materiality are: Step 1: Plan a preliminary judgment about materiality. The auditor establishes a preliminary judgment about materiality by choosing a base, or bases, which is multiplied by a percentage factor to determine the initial quantitative judgment about materiality.

This amount can be adjusted for qualitative factors that may be relevant for the engagement. 17 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E Step 2: Determine tolerable misstatement. This step involves determining tolerable misstatement based on planning materiality. Tolerable misstatement is the amount of planning materiality that is allocated to the account balances or classes of transactions so that the auditor can plan the scope of audit procedures for the individual account balance or class of transactions. Step 3: Estimate likely misstatements and compare the totals to the preliminary judgment about materiality.

The auditor aggregates likely misstatements from each account or class of transactions and compares the likely misstatements to the preliminary judgment about materiality. When the likely misstatements are less than the preliminary judgment about materiality, the auditor concludes that the financial statements are fairly presented. Conversely, when the likely misstatements are greater than the planned judgment about materiality, the auditor should request that the entity adjust the financial statements. 3-11 Total assets or total revenues are better bases for determining materiality for many entities because these factors are more stable and less variable from year to year than is net income.

Difficulties arise when using net income, or a variant of net income, as a base when the entity is close to breaking even or experiencing a loss. 3-12 Qualitative factors that may affect the establishment of the preliminary judgment about materiality include: • Detection of material misstatements in prior years. • Small amounts may violate covenants in a loan agreement. • Small amounts may affect the trend in earnings. 3-13 Four qualitative factors that may affect the establishment of the evaluation of materiality: 1. Whether the misstatement masks a change in earnings or trends. 2. Whether the misstatement hides afailureto meet analysts’ consensus expectations. .

Whether the misstatement changes a loss into income or vice versa. 4. Whether the misstatement concerns a segment or other portion of the business that has been portrayed as playing a significant role in the operations or profitability of the entity. Answers to Multiple-Choice Questions 3-14 3-15 3-16 3-17 3-18 D A C C D 3-19 3-20 3-21 3-22 3-23 C A B A A Solutions to Problems 3-24 a. 1. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the auditor's opinion on financial statements that are materially misstated. 2. Inherent risk is the susceptibility of an assertion to material misstatement, assuming no 18

Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E 3. related internal controls. Control risk is the risk that material misstatements that could occur will not be prevented or detected by the internal controls. Detection risk the risk that the auditor will not detect a material misstatement that exists in the financial statements. Inherent risk and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor's procedures and can be changed at the auditor's discretion. Detection risk has an inverse relationship to inherent and control risk.

Materiality is the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. This concept recognizes that some matters, either individually or in the aggregate, are important for the fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not. Materiality is affected by the nature and amount of an item in relation to the nature and amount of items in the financial statements under examination, and the auditor's judgment as influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements. A number of qualitative factors also affect materiality.

The auditor's judgment about materiality for planning purposes may be different from materiality for evaluation purposes because the auditor, when planning an audit, cannot anticipate all of the circumstances that may ultimately influence judgment about materiality in evaluating the audit findings at the completion of the audit. If significantly lower materiality levels become appropriate in evaluating the audit findings, the auditor should re-evaluate the sufficiency of the audit procedures already performed. Client No. 1 2 3 4 Detection Risk 25% 10% 80% 25% Detection Risk Moderate High Low Low b. 1. 2. 3. 3-25 3-26 Client No. 1 2 3 4 19 Solutions Manual to accompany Auditing and Assurance Services in Malaysia 3E 3-27 1. 2. 3. 4. 5. 6. 7. 8. 9. 10. b d c b b c d d a d 3-28 a. Two factors are particularly important in assessing the risk of material misstatement for Alex Services.

First, one individual, who also has majority control of the issued share capital, dominates the decision making in the company. This factor should lead to a higher assessment for the risk of material misstatement because there is no review of important decisions and actions may be taken that are not in the best interest of the company or its shareholders. Second, Alex Services is expanding rapidly in its operations. Such expansion may result in material misstatements since decision making may become decentralised without adequate internal control. The increase in the risk of material misstatement due to these two factors will result in a lower determination of detection risk and an increase in the scope of the auditor's work. b.

A number of the risk factors are present for CM Stores. First, the company is experiencing a slowdown in sales. Second, there has been turnover in two financial positions within the company. Third, the chairman of the company is aggressive and places undue emphasis on meeting earnings expectations. These factors lead to an increased assessment for the risk of material misstatement, resulting in a lower assessment of detection risk and more substantive testing. c. The factors affecting the assessment of the risk of material misstatement for EML all relate to industry characteristics. First, the industry is very competitive, which can lead to pricecutting and its related effects on revenues.

Second, the industry is affected by changes in technology, and EML is not one of the industry leaders in technology. Its products usually are not competitive with the industry leaders in terms of performance. Third, the company is not as profitable or financially strong as the major companies in the industry. The industry factors result in an increased assessment of the risk of material misstatement for EML, leading to a lower determination of detection risk and more substantive procedures. d. The risk of material misstatement should be increased for Premier for the following reasons. First, the audit firm has been the company’s auditors for only two years.

Second, there has been contentious accounting issues related to provision for doubtful debts and the value of collateral. Third, prior audits have indicated the presence of misstatements in the provision for doubtful loan receivable. Based on these risk factors, detection risk should be set lower and increased substantive procedures performed. 3-29 a. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements a